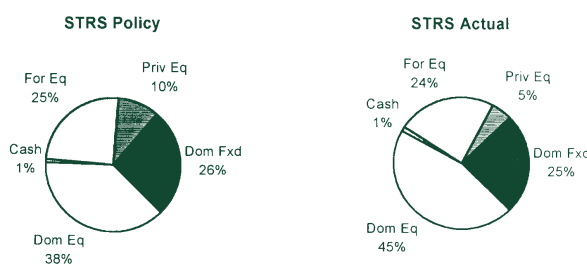




The CalSTRS investment portfolio grew by \$11.6 billion over the past year reaching a value of \$99.9 billion on June 30, 1999. As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

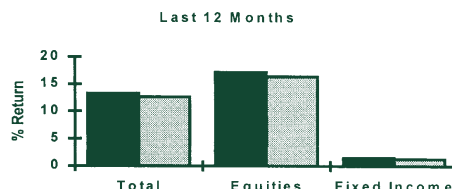
## Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The second quarter report reflects asset allocation guidelines adopted by CalSTRS on July 1, 1997 (see left chart). The portfolio's actual allocation is modestly different from policy. Private equity, foreign equity and domestic debt are underweighted while domestic equity is overweighted (see right chart).

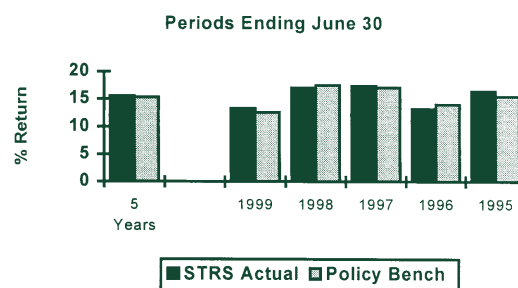


## Investment Results

Over the last year, the CalSTRS investment portfolio produced an overall return of 13.4% ranking in the top quartile of its large public pension fund peers<sup>1</sup> (top bar chart). The portfolio outperformed policy by approximately 70 basis points largely due to strong relative performance by the foreign equity, private equity and domestic debt asset classes.<sup>2</sup>



During the last three years, CalSTRS' portfolio generated a 15.9% (third quartile) return versus 15.7% for the policy benchmark. Over the last five years, the CalSTRS investment portfolio produced an average annual return of 15.5%, exceeding its policy benchmark by 20 basis points (bottom chart). Successive one-year periods are shown as well. For periods ending June 30, CalSTRS' portfolio has outperformed its policy benchmark in three of the latest five one-year periods.



Recent performance has significantly improved CalSTRS ranking among its peers over the one-, three- and five-year periods.<sup>3</sup>

*Pension Consulting Alliance, Inc.*

<sup>1</sup> Per TUCS Universe for Public Funds with assets in excess of \$1 billion.

<sup>2</sup> The policy benchmark consists of passive managed asset class portfolios weighted by STRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of STRS and its investment managers.

<sup>3</sup> STRS' investment performance is calculated using a monthly internal rate of return with day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards.

# Investments

The market value of the CalSTRS investment portfolio reached almost \$100 billion on June 30, 1999. The \$99.9 billion represented a gain of \$11.6 billion over the same period last year. This dollar gain represented a return of 13.4 percent. More significantly, however, is the fact this result allowed CalSTRS to outperform its benchmark by 70 basis points, adding \$700 million to the fund. Nearly all the asset classes exceeded their benchmarks, from the international equity to the private equity to domestic debt. These strong results allowed CalSTRS' portfolio to outperform 79 percent of the others in its peer group of large public funds. While 1999's results represented an improvement over 1998, these results are significantly better than one year ago, when CalSTRS performed better than only 37 percent of its peer group of large public funds. At the end of the last fiscal year, CalSTRS' portfolio allocation across asset classes was as follows: Equity, Domestic and International 70 percent; Fixed Income, Domestic 25 percent; Private Equity 5 percent.

CalSTRS continues to follow its established long-term strategies. The results achieved this year and last year reaffirm the asset allocation decisions made by the Teachers' Retirement Board in 1997.

Chart A (below) illustrates the growth in the total investment portfolio, excluding securities lending collateral, from June 30, 1985 through June 30, 1999. Chart B shows CalSTRS' returns against the actuarial rate, which is the long-term assumed rate of return for the fund. Chart C shows the performance returns for all of the asset classes in the portfolio and the benchmark indices. The return calculations are consistent with Association for Investment Management and Research performance presentation standards. These returns are shown over 1-, 3-, 5-, and 10-year periods.

## Objectives

The objectives of the Investment Management Plan are the same as they were this time last year. CalSTRS continued to increase its commitment to active management over the last year. As of June 30, 1999, CalSTRS had 16 active domestic equity managers and 16 active international equity managers. CalSTRS will continue to seek a close alignment between policy and actual allocations.

## Fixed Income

CalSTRS has fixed income assets totaling approximately \$25 billion in market value. As of June 30, 1999, the treasury/agency portfolio represented a majority of the assets, with \$8.4 billion. The high-grade corporate bond portfolio with \$7.8 billion and the mortgage-backed securities portfolio with \$7.3 billion in assets, respectively completed the balance of the fixed income portfolio. For the fiscal year ending June 30, 1999, all the long-term fixed income portfolios exceeded the performance benchmark return by 20 basis points, amounting to approximately \$50 million for the Teachers' Retirement Fund.

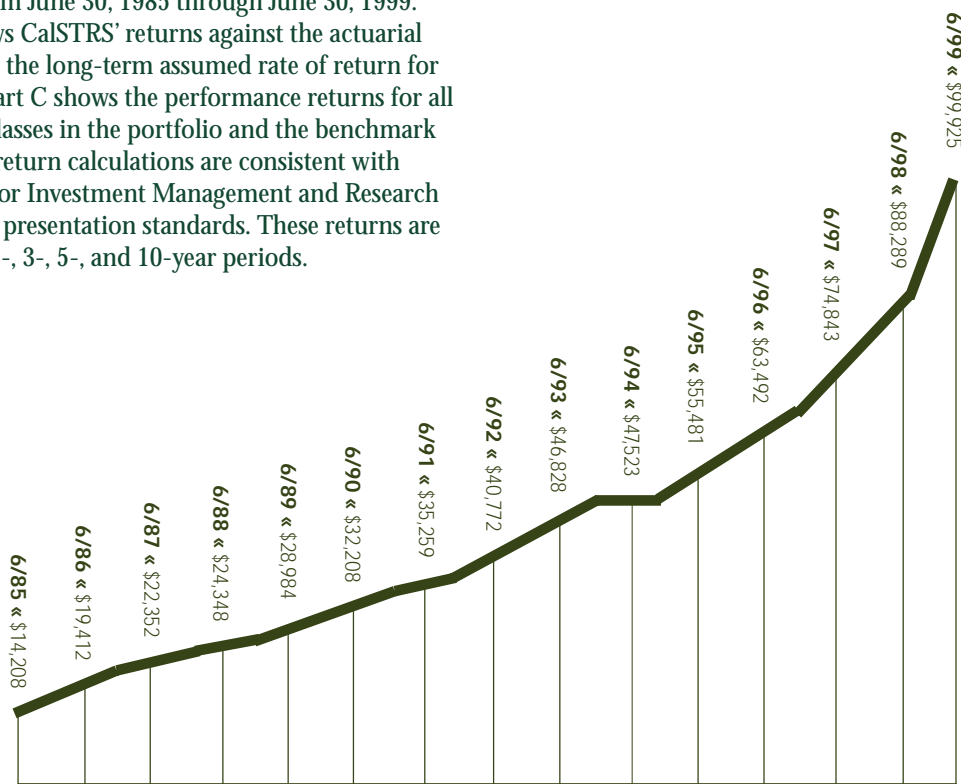
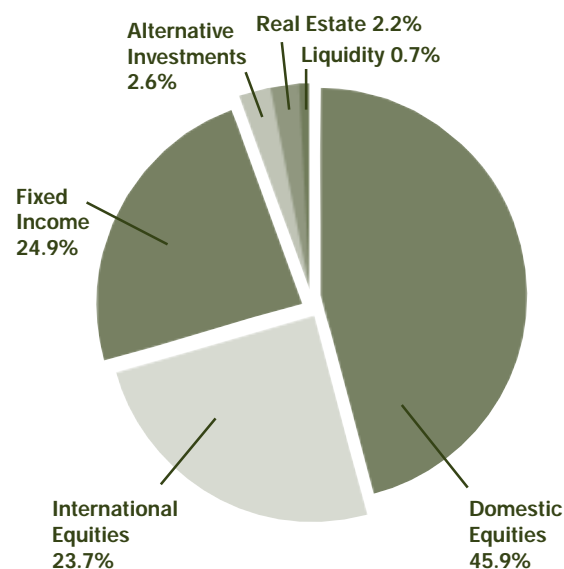
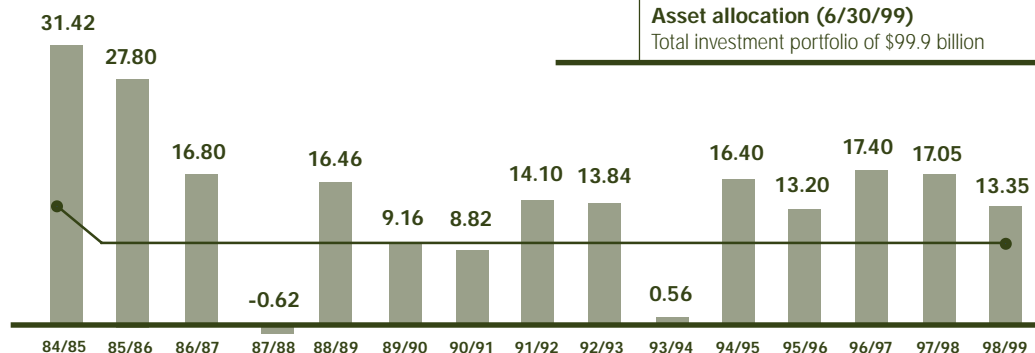


Chart A Growth in total investments (in millions)

CalSTRS also maintains a short-term portfolio, known as the liquidity portfolio, which is utilized for cash and liquidity purposes. This portfolio had approximately \$739 million in assets at fiscal year end. While CalSTRS' goal is to be fully invested at all times, benefit payments and asset allocation decisions necessitate the need for short-term highly liquid assets that provide a competitive rate of return until re-deployed into other asset classes. The liquidity portfolio exceeded its performance benchmark return by 120 basis points for the fiscal year ended June 30, 1999.



**Chart B** | Growth in CalSTRS' returns (percent)



**Chart C** | Performance returns for major asset categories

Portfolio Type/Associated Indices	1 Year	3 Years	5 Years	10 Years
<b>Total Fund</b>	<b>13.35</b>	<b>15.91</b>	<b>15.47</b>	<b>12.28</b>
<b>Domestic Equity</b>	<b>19.29</b>	<b>25.09</b>	<b>24.75</b>	<b>17.35</b>
Russell 3000	20.10	26.41	26.03	17.93
Wilshire 5000	19.59	25.84	25.69	17.62
<b>Int'l Equity</b>	<b>12.89</b>	<b>9.38</b>	<b>9.53</b>	<b>na</b>
MSCI All Country Free ex US (G)	9.53	8.22	7.95	6.92
MSCI Europe, Australia & Far East	7.61	8.81	8.21	6.60
MSCI Emerging Market Free	28.71	-4.00	-0.83	12.31
<b>Fixed Income</b>	<b>1.54</b>	<b>8.45</b>	<b>9.24</b>	<b>9.00</b>
Salomon LPF	1.34	7.93	8.81	8.95
<b>Real Estate</b>	<b>21.21</b>	<b>17.12</b>	<b>13.36</b>	<b>6.00</b>
Real Estate Custom*	13.75	12.94	10.84	5.43
<b>Alternative Investments</b>	<b>16.45</b>	<b>28.25</b>	<b>27.87</b>	<b>16.31</b>
Alternative Investments Custom**	12.58	13.67	14.41	na
<b>Liquidity</b>	<b>5.91</b>	<b>6.04</b>	<b>5.92</b>	<b>6.06</b>
Salomon 3-Month Treasury Bill	4.71	5.07	5.20	5.22

(All performance calculations are conducted in accordance with the presentation standards of the Association for Investment Management and Research)

\*NCREIF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter

\*\*Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter

In addition, CalSTRS has three other fixed income programs: Home Loan, Currency Hedging and Securities Lending.

#### *Home Loan Program*

Legislation that became effective earlier this year broadened CalSTRS' ability to offer home loans with different interest rates, terms, and conditions. Last fiscal year CalSTRS funded more than \$40 million in home loans, bringing the total since origination in 1986, to \$2.5 billion. Correspondent lending firms participating in the Home Loan Program expanded from two to 10, with plans to bring on more firms as the year progresses.

#### *Currency Hedging Program*

The strategic objective for this three-year-old program is to reduce risk in the passively managed segment of the international equity portfolio. CalSTRS currently hedges a portion of its international stock exposure in order to protect these assets against a strengthening U.S. dollar in both Asia and Europe. To date, the Currency Hedging Program has generated more than \$425 million in additional income to the TRF.

#### *Securities Lending Program*

CalSTRS has been lending securities since 1988; this represents CalSTRS' first and longest running "off-balance sheet" program. The program was designed to enable CalSTRS to use its existing asset base and

investment expertise to generate additional income. The amount of income earned as a result of the Securities Lending Program is based upon such factors as the types and amounts of stocks and bonds held by CalSTRS, the volume of securities loaned, the appetites of the financial markets for CalSTRS' inventory of securities and the reinvestment of the cash taken in as collateral. Over the last fiscal year, CalSTRS has earned more than \$60 million from this activity; since inception, the program has earned approximately \$300 million.

#### **Alternative Investments**

This fiscal year, CalSTRS made additional commitments of nearly \$1 billion in this segment of the portfolio. Total commitments now amount to approximately \$5.3 billion or 5 percent of the total portfolio. There are 79 partnerships and two co-investments in the alternative investment portfolio. At the end of the fiscal year, the total market value was \$2.6 billion, representing nearly 3 percent of the total CalSTRS portfolio. CalSTRS continued to increase its commitment in this area as a result of the allocation review completed at the end of June 1997. The alternative investment asset class has achieved annualized returns of 16, 28 and 28 percent, for the 1-, 3- and 5-year periods, respectively.

#### **Internal Equity Management**

During 1999, CalSTRS increased the allocation to internal equity management by \$5 billion. As of June 30, 1999, the internally managed S&P 500 indexed portfolio had a market value of more than \$6.3 billion.

**Chart D** | Largest fixed income holdings as June 30, 1999 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Maturity Date	Interest Rate	Par	Market Value	Average Cost	Unrealized Gain/(Loss)
US TREASURY	15-Nov-2015	9.88%	994,000,000	1,447,820,640	1,299,995,917	147,824,723
US TREASURY	15-Feb-2019	8.88%	915,000,000	1,260,266,100	907,272,993	352,993,107
US TREASURY	15-Feb-2016	9.25%	845,000,000	1,175,344,300	1,001,088,744	174,255,556
US TREASURY	15-May-2016	7.25%	950,700,000	1,113,802,092	994,739,086	119,063,006
US TREASURY	15-Feb-2020	8.50%	780,000,000	1,045,441,800	927,765,654	117,676,146
US TREASURY	15-Aug-2017	8.88%	715,000,000	974,745,200	769,072,744	205,672,456
US TREASURY	15-Nov-2016	7.50%	607,000,000	728,685,290	601,080,007	127,605,283
US TREASURY	15-Aug-2013	12.00%	472,375,000	700,371,518	628,953,592	71,417,926
US TREASURY	15-May-2017	8.75%	475,000,000	639,692,000	472,957,195	166,734,805
US TREASURY	15-Aug-2019	8.13%	448,000,000	578,197,760	459,702,261	118,495,499

**Chart E | Largest equity holdings as June 30, 1999** (CalSTRS maintains a complete list of portfolio holdings)

Issue	Shares	Market Value	Average Cost	Unrealized Gain/(Loss)
Microsoft Corp.	16,742,266	1,509,943,114	355,488,917	1,154,454,197
General Electric Co.	10,635,141	1,201,770,933	351,207,169	850,563,763
International Business Mach	6,049,501	781,898,004	233,381,196	548,516,808
Wal Mart Stores Inc.	14,337,262	691,772,891	160,374,165	531,398,726
Cisco Systems NC	10,563,584	681,138,079	126,961,869	554,176,209
Lucent Technologies Inc.	10,070,481	679,128,106	141,752,002	537,376,103
Intel Corp.	10,644,158	633,327,401	151,960,405	481,366,995
Exxon Corp.	7,643,877	589,534,013	257,256,751	332,277,262
AT&T Corp.	10,502,425	586,166,602	290,923,510	295,243,092
Merck & Co Inc.	7,779,433	574,744,392	184,208,166	390,536,226

The performance objective of the internally managed passive portfolio is to track closely the return of the S&P 500 Index. During the period between June 1998 and June 1999, the S&P 500 indexed portfolio returned 22.7 percent, matching the benchmark S&P 500 Index return.

### Real Estate

Over the last fiscal year, CalSTRS portfolio of real estate assets reached \$2.2 billion. Forty-two directly owned properties and three privately owned partnerships represented this dollar amount. Real estate represents slightly more than 2 percent of the total portfolio. The direct property portfolio is diversified as to property type and geographic location. The two largest components of the direct property sector are office and industrial buildings, located in the western region of the United States. The CalSTRS' real estate portfolio has achieved annualized returns of 21, 17 and 13 percent, for the 1-, 3- and 5-year periods, respectively.

### Credit Enhancement

CalSTRS has entered into agreements with a number of issuers of non-taxable debt to guarantee the payment of principal and interest for specified default events. To reduce risk while increasing incremental return, CalSTRS is paid a fee over the term of the agreement. The majority of the transactions are supported by collateral, letters-of-credit from banks or bond insurers for repayment. As of June 30, 1999, the credit enhancement program had commitments of approximately \$665 million and fee income earned over the year was almost \$2 million.

### External Equity Management

In fiscal year 1998–1999, this segment of the portfolio accounted for 70 percent (or \$69.5 billion) of the total portfolio. Domestic equity was 46 percent of the total equity allocation, while international equity accounted for the remaining 24 percent. Although public equity was overweighted relative to the policy target, the overweighting is due to private equity commitments that are currently unfunded. The policy is monitored on a continuing basis and as commitments are funded in alternative investments and real estate, these interim overweights are reduced. Thus, the portfolio is not allowed to drift away from the strategic asset allocation targets or take unintentional “bets.”

### Corporate Governance

During the 1998–99 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. CalSTRS cast 6,588 votes on proxy issues of corporations whose shares were owned in the investment portfolio. These proxy issues were presented on 2,617 companies. Although the overall number of proxy issues declined from 7,521 last year and the number of companies reviewed declined from 2,889 companies, the number of mergers/acquisitions reviewed remained constant, at a little more than 10 percent. The steady completion of mergers, especially where stock is the compensation received by the acquired company's holders is a result of the appreciation in the stock market.

CalSTRS reviewed 44 percent fewer shareholder resolutions on tobacco issues than last year, while resolutions regarding the MacBride and CERES Principles remained constant. The Master Settlement Agreement between the tobacco companies and the states' attorneys general probably had a significant impact on the tobacco activism. The state of California

is expected to receive about \$1 billion annually for the next 25 years under the terms of this agreement.

The major issues voted are summarized below:

1. **Election of Directors:** CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment and classification of the company directors.

*Number Voted: 2,372*  
*For: 1,863*  
*Against: 509*

2. **Selection of Auditors/Accountants:** CalSTRS generally votes in favor on the independent auditors and accountants recommended by management.

*Number Voted: 1,441*  
*For: 1,441*  
*Against: 0*

3. **Compensation Plans:** These are issues related to the incentive plans offered to the top employees of corporations. CalSTRS votes in favor of these plans as long as the incentive offered aligns shareholder interests with that of the management.

*Number Voted: 969*  
*For: 329*  
*Against: 640*

**Chart F** | Investment summary for the year ended June 30, 1999 (in millions)

Portfolio Type	30-Jun-98		30-Jun-99			
	Book Value	Market Value	Book Value	Market Value	% of Market Value	Net Market Change
Domestic Equity	16,498	36,058	20,996	45,838	45.88%	9,780
International Equity	16,498	18,511	19,021	23,686	23.70%	5,175
Fixed Income	23,592	25,970	24,880	24,902	24.92%	(1,068)
Global Asset Allocations	2,172	2,586	–	–	0.00%	(2,586)
Alternative Investments	1,526	1,986	2,155	2,590	2.59%	604
Real Estate	1,934	2,062	2,360	2,170	2.17%	108
Liquidity	1,116	1,116	738	739	0.74%	(377)
<b>Total Portfolio</b>	<b>63,336</b>	<b>88,289</b>	<b>70,150</b>	<b>99,925</b>	<b>100.00%</b>	<b>11,636</b>
Plus: Securities Lending Collateral		16,996		15,516		
Less: Accruals		376		362		
<b>Plan Net Assets–Investments</b>		<b>104,909</b>		<b>115,079</b>		

**Chart G** | Schedule of fees July 1, 1997 through June 30, 1999 (in thousands)

	Assets Under Management	Fees	Basis Points
<b>Investment Managers' Fees:</b>			
Domestic Equity	\$45,838,529	\$6,370	1.4
International/Global Managers	23,685,453	28,534	12.0
Alternative Investments	2,589,720	733	2.8
Real Estate	2,170,060	4,860	22.4
<b>Total Investment Managers' Fees</b>	<b>\$74,283,762</b>	<b>\$40,497</b>	<b>5.5</b>



**Chart H | Broker commissions** (July 1, 1998 through June 30, 1999)

Broker Name	Commission	Shares	Commission per share
<b>Domestic Equity Transactions</b>			
MORGAN STANLEY AND CO, INC	650,292	15,978,590	0.041
SALOMON SMITH BARNEY	545,423	14,041,580	0.039
CAPITAL INSTITUTIONAL SERVICES	474,730	9,203,935	0.052
INVESTMENT TECHNOLOGY GROUP INC	444,825	19,993,133	0.022
LEHMAN BROS INC	398,564	12,512,658	0.032
MERRILL LYNCH PIERCE FENNER + SMITH	389,214	8,963,737	0.043
INSTINET	338,180	20,412,686	0.017
GOLDMAN SACHS + CO	335,758	11,953,866	0.028
SEIDLER COMPANIES	330,380	6,611,211	0.050
JACKSON PARTNERS + ASSOCIATES INC	309,479	5,323,940	0.058
OTHER DOMESTIC	6,598,213	142,912,086	0.046
<b>Total Domestic</b>	<b>10,815,060</b>	<b>267,907,422</b>	<b>0.040</b>
<b>International Equity Transactions</b>			
MERRILL LYNCH	2,087,271	295,431,216	0.007
MORGAN STANLEY	1,231,788	97,377,589	0.013
GOLDMAN SACHS	920,104	62,594,426	0.015
INSTINET	914,448	31,940,579	0.029
HSBC	811,845	24,917,458	0.033
DRESDNER KLEINWORT BENSON	737,660	27,218,991	0.027
WARBG WARBURG DILLON READ LLC	690,141	43,571,369	0.016
SALOMAN BROS	601,673	60,470,649	0.010
CS FIRST BOSTON	563,798	36,317,092	0.016
KLEINWORT, BENSON NORTH AMERICA INC	479,273	23,030,252	0.021
OTHER INTERNATIONAL	8,608,971	1,401,092,547	0.006
<b>Total International</b>	<b>17,646,972</b>	<b>2,103,962,168</b>	<b>0.008</b>

**4. Corporate Actions/Corporate Governance Issues:**

These are issues related to mergers, acquisitions, stock issuance, stock splits and incorporation. CalSTRS generally votes in favor of these proposals unless there is a compelling reason not to cast a positive vote.

*Number Voted: 696*

*For: 406*

*Against: 290*

**5. Shareholder Proposed Issues Social and**

**Financial:** These are shareholder-submitted issues and are reviewed generally on a case-by-case basis. Previously established policy and the expressed philosophy of the Teachers' Retirement Board are also important considerations.

*Number Voted: 105*

*For: 64*

*Against: 41*

6. **Miscellaneous Issues from Both Shareholders and Management:** These are reviewed on a case-by-case basis.

*Number Voted: 1,005*  
*For: 628*  
*Against: 377*

#### **Cash Balance Benefit Program**

The Cash Balance Benefit Program contributions are invested at the direction of the Teachers' Retirement Board in internally pooled portfolios of the Teachers' Retirement Fund. Sixty percent of the contributions are allocated to the S&P500 portfolio and 40 percent to the Government Index portfolio. The CB Benefit Program has ownership of units of these pooled portfolios that reflect market fluctuations of underlying securities on a daily basis. Income and expenses are distributed to each pooled portfolio on a pro rata basis determined by the number of units owned as a percentage of the total units of the portfolio.

Contributions in the CB Benefit Program began on February 1, 1997. The investment value of those contributions as of June 30, 1999, is \$4.8 million. For both portfolios, the combined total return for the past year was 16.6 percent. Since their inception, these portfolios have achieved a return of 22.1 percent. The benchmark returns for the past year were 22.7 percent for the S&P500 and .34 percent for the Salomon Brothers Large Pension Fund-Treasury.